Shari'ah Supervisory Board, Corporate Governance and Performance of Islamic Banks: Evidence from Pakistan Emerging Market

*Muhammad Sadiq Shahid
**Muhammad Rizwan
***Muhammad Hassan
****Mehreen Khalil

Abstract

After the outbreak of financial crises in the Asian countries, a great attention was given on improving the corporate governance (CG) practices, and a number of studies were conducted to explain the influence of CG on the bank's performance. The CG reforms were implemented and enforced to protect the interest of the shareholders and other stakeholder.Existing literature has focused on the influence of CG practices and its influence on the non- financial firms. There is a dearth of literature on the effect of CG on Islamic financial institutions, particularly Islamic banks, which have to comply not only with the CG principles but also with the Islamic Shari'ah principles. This study examines the influence of CG practices and the Shari'ah supervision on the performance of Islamic banks in Pakistan from 2012-2015. The Shari'ah board performs either supervisory or advisory role. The findings suggest that Shari'ah boards in the supervisory position positively affect the performance; however, the effect on the performance is not significant when the board has an advisory role. The finding also suggests the board size, board independence and CEO duality affect the performance of Islamic banks in Pakistan.

Keywords: Sharia supervision; Islamic banking; Corporate Governance; Banking performance

1. Introduction:

The scholarship in accounting and finance has given attention to explore the relationship between corporate governance (CG) practices and firms performance since the Asian financial crisis in 1997[1] After the scandals like Enron in 2001, and WorldCom in 2002 and Royal Ahold in 2003[2] [3] governance became an important issue for the corporate banks. In the past, the CG was an issue mostly for the large corporates in the Europe and North America. However, after all these scandals, the market regulators in the Asian markets formulated guidelines and started emphasising the companies to execute the CG practices to protect the interests of all the shareholders[4].Particularly, in last decade, the regulating bodies emphasised on implementing different reforms to improve CG at the firm's level that led towards improving their financial performance [5].

*Assistant Professor, Institute of Management Sciences, Bahauddin Zakariya University, Multan.
**Assistant Professor, Institute of Management Sciences, Bahauddin Zakariya University, Multan.
***Assistant Professor, Institute of Management Sciences, Bahauddin Zakariya University, Multan.
****Lecturer, Institute of Management Sciences, Bahauddin Zakariya University, Multan.

There is no dearth of literature explaining the relationship between the CG enforcement and financial performance, and a large body of research was produced to explore and explain this relationship[(6)].However, in most of the cases, the sample was taken from non-financial firms[(7)].Particularly, with reference to Pakistan a number of studies were conducted on CG area [(8)]; however, little emphasis was given to the financial firms, particularly those who apply the Shari'ah compliance. This study aims to investigate the impact of Shari'ah board and corporate governance on Islamic banking performance

The rationale behind studying the CG of the banks impinges on the differences in the organization structure of the banking and non-banking firms. Non-financial firms are regulated by the market authorities like SECP in Pakistan, on the contrary; banks have to follow the regulations from SECP as well as the central banks.The banks may have an issue of moral hazard in its operation and banks' resources can be expropriated by the state agencies if they are involved in any form of theft, asset stripping, transfer pricing, and hiring family members. Moreover, banks may be exposed to a problem of information asymmetry; therefore, regulators require a higher level information disclosure to protect the stakeholders. The banks that are operated under the Sharia supervision have to implement the guidelines devised by the Sharia. Therefore, these banks operate in different regulatory environment form the conventional banks, and it is worth investigating the influence of CG practices on the financial performance in the Sharia compliance banks.

Islamic Banks in Pakistan:

The idea of Islamic finance is becoming popular and has grown rapidly in the last two decades in the whole world[(9)]. In Pakistan, Islamic banking system was adopted in a response to both religious and economic demands. The state has been taking steps to eliminate *Riba*from the financial system since 1970s. The Islamic financial market saw significant changes in the Islamic banking system in Pakistan in the early 2000s, when the full fledge Islamic banks started their operations (See: SBP 2008). This system allowed *Shari'ah* compliance by offering *Riba-free*instruments like *Mudaraba*, and other products. The other conventional banks started offering Islamic Finance products by opening Islamic banking branches. The banks providing Islamic Financial products are obliged to establish a *Shari'ah* compliance board, which ensures that the products and practices of Islamic banks are free from Riba.The Sharia compliance board restricts the Islamic banks' operations by helping banks to make batter disclosure and transparency to ensure that the banks are following Sharia guidelines[(10)]

This paper examines the effect of *Shari'ah* supervisory board and CG on the performance of Islamic Banks in Pakistan. Specifically, we have examined the ethical behaviour of banks and its relationship with enhanced efficiency and return on investment. This paper contributes in the Islamic banking literature in the area of corporate governance and its impact on Islamic Banking performance.It can may help attract a new customer base, as well as opportunities for developing new Islamic banking products.

This paper is divided into four sections. The first section develops the framework using existing literature about Islamic Finance and Corporate Governance. The second part discusses the methodology, provides details about the data collection, the population and sample, and the data analysis.

The performance of Islamic Banking sector:

As a result of oil boom during 1970s, in the Muslims countries of the Gulf region there was a great demand for the Islamic banking products. In 1975, the first Islamic bank was founded in Dubai with the name of the Dubai Islamic Bank. Initially, the bank offered a very limited line of products, for example, safekeeping accounts, sale and PLS contract. To fulfil the demand of the conventional mutual and hedge funds, the first Islamic equity funds were launched in the early 1990s. *Shari'ah* compliance insurance products *'takaful'*were introduced in the late 1990s. The 21st century witnessed the launch of Islamic indexes from Dow Jones, FTSE and in recent times from S&P, so that investors can distinguish the firm'sperformancewhichoperatesin accordance with Islamic law.

With a particular reference of Pakistan, Islamic banking system continued its growth momentum as both assets and deposits witnessed an increase over the time period. In 2015, assets of IBI reached Rs 1,495 billion by the end of June 2015 as compared to Rs 1,302 billions in the previous quarter depicting a growth rate of 14.8%. In the same way, deposits were also recorded growing to Rs 1,281 billions in 2nd quarter as compared to Rs 1,122 billions in the first quarter. Overall, market share of Islamic banking also increased during the 2015 reaching to11.3% and 12.8% respectively. Though the financial crises hit hard the conventional banks; however, the Islamic banking industry exhibitedahigh pattern both locally and globally. A brief overview of Islamic banking industry is shown in the table 1.

Table 1: Islamic banking system progress in Pakistan

	Industry Progress (Rs. Bill.)			**Growth (YoY)**			**Industry Share (%)**		
	Mar-14	Mar-15	Mar-16	Mar-14	Mar-15	Mar-16	Mar-14	Mar-15	Mar-16
Total assets	1016.0	1302.0	1506.0	20.0%	28.2%	39.4%	9.4%	10.4%	11.8%
Deposits	872.0	1122.0	1296.0	23.9%	28.7%	32.6%	10.7%	12.2%	14.5%
Net Financing & Investment	662	768	832	02.0%	16.0%	19.5%	7.6%	7.5%	8.2%
IBS	20	22	26						

(Source: Islamic Banking Department, SBP)

Islamic Jurisprudence and Shari'ah Board Supervision:

The Banking Law of 2000, in Pakistan requires from all the Islamic banks that they have to establish an Islamic Jurisprudence Supervision Board or *Shari'ah*Board, who can ensure that the banking products and the transactions are in line with the principles of Islamic jurisprudence. This law requires that there shall be at least three members of the *Shari'ah* board. These members should be an authority on the Islamic Jurisprudence. The members have collective responsibility to monitor and ensure that the operations and products of the banks are in line with the *Shari'ah.* The board also provide their expert opinion on the text of the contracts between the banks and its customers. They may also consider any matters time to time referred by the Central Bank. The *Shari'ah* Board is ranked above the Board of Directors and possesses a power to issue a decree or in other words, *Fatwa* about the matter presented in front of them about any matter. This unique set up makes Islamic banks different from other r conventional banks.

The conventional banking earns their profit based upon the interest earnings; on the contrary, for Islamic banks charging, interest is prohibited. These banks operate under the regulations guided by *Shari'ah*law, which prohibitspaying interest, generally known as r*iba* in the Islamic financial system. Therefore, Islamic banks cannot offer interest based services; the PLS (profit and loss) instruments do not guarantee a pre-defined margin to its depositors, and some banks Islamic banks offer fixed fee-based services to its clientele.

The Shari'ah compliance board is responsible to supervise the developments of all banking products, Analyse agreements and contracts of bank's transactions, prepares annual reports on the banks' balance sheets concerning Shari' ah compliance, ensures the immediate correction of the breaches, (if any) in compliance to Shari' ah, Analysing unforeseen situations not covered in routine, provides Shari'ah training for the bank staff, and issuesShari'ah pronouncements (*fatwas*) for routine business. The figure 1 provides a brief overview of the roles a Shariah compliance board performs.

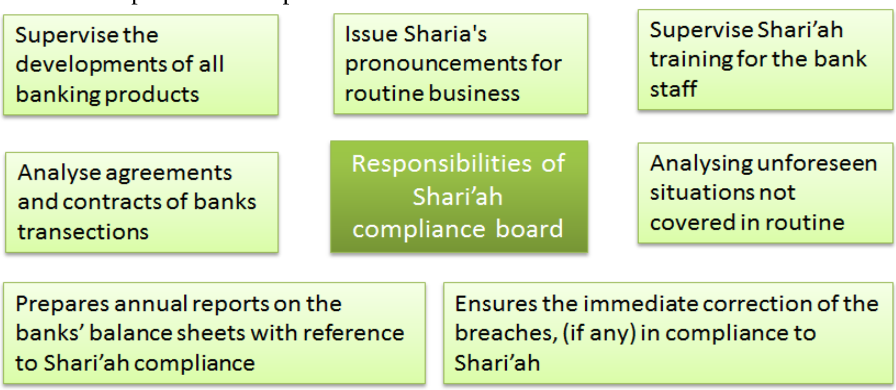

Figure 1: The Role of Shari'ah Compliance board in the banking system

Islamic banking is becoming popular in the whole world. However, in most of the world, both Islamic and traditional banking is practicing simultaneously. Some Muslim countries have gone even a step further to claim that they want to convert the entire banking from traditional to Islamic(23). Islamic banking is guided by Shari'ahlaw, which prohibits interest payment (riba). Islamic banks do not offer any guaranteed return to their depositors, rather they use profit-and-loss sharing (PLS) instruments [1] . Some of the Islamic banks offer fee-based services to their customer[2].On the contrary, the conventional banking is based on interest, and they earn profits by extending loans to their creditors and charge a relatively higher amount of interest than the rate they offer to their depositors.

Corporate Governance and Islamic banks:

It is noted that the principles of CG ensure protecting the interest of all stakeholders. The block shareholders which have a large number of shares can misuse their power and work against the interest of the majority shareholders(11). For example, in the case of large conglobates similar to the Chaebols in Korea, these minority shareholders may expropriate money through "Tunneling" to benefit their own business interests against the will of the majority shareholders(12). To ensure transparency and protecting the rights of all stakeholders CG principles are advised to all corporations, including banks. In this way, the Islamic banks have to comply with the *Shari'ah* as well as CG principles at the same time. Brief summary of three CG principles is discussed in the section below.

CEO Duality. The CG practices do not allow the CEO duality and advise that the leadership within a firm should follow a separated leadership structures(13). To comply with this principle, the chairman of the board and CEO should be acquired by two different people. This separation ensures less contracting is needed and reduces the information asymmetry (14).

Board Size: The board of directorsis responsible to make policy decisions. In some cases, it is believed that larger boards are appropriate, and they can contribute positively to the business performance. The appropriateness of the board size may also depend upon the nature of the firm, whether financial or non-financial(14).Haniffa&Cookeareof the view that a smaller board may help improve performance, a board larger than seven or eight members may not perform effectively. Jensen extends that larger board size may cause free-riding problem, and the decision making may become a lengthy process(15). Similarly Eisenberg &Sundgrenwho used ROA and operating margin to measure the performance and found a negative association between the board size and performance(16). With the reference to the financial firms, Cornett et al., argued that a larger board has a significant negative association with the abnormal return of the bidding bank involved in diversifying acquisitions(17).

Board Independence:Thisrefers the proportion of outsidersdirectorsinto the board of directors. It is advised that if there is a larger percentage of an outside director on the board, it represents the greater independent of the board. Studies have

found that an independent board is more efficient supervising managers and ultimately leads to greater performance [18].The greater board independence will reduce the agency cost, and provides access to financial market in addition to make sure responsibility in executive remuneration. The positive aspect of having board independence has been shown in a study by Cook et al.[19]. They highlighted that the survival of firms in the thrift crisis is due to greater proportion of independent directors in the board. In the same way, Petra mentionsthat board independence may play a role in effectivemonitoring management aspects, for instance, takeover hazards, CEO reimbursement and directors nominations[20]. Moreover, Cornett et al., provide evidence that higher percentage of outsiders on board escorts to higher bank returns[17].

The Audit Committee:The external auditors also play a vital role in the enforcement of CG practices. A high-quality audit ensures transparency and keeps the stakeholders informed about financial difficulties a bank may face in the future[21].In the presence of quality audit firms, the other stakeholders havefewer incentives to monitor the performance. By appointing a reputable external audit firm, the interest of the stakeholder is greatly protected[11].

Based on the above discussion, the research hypotheses are as follows:

H1: There is a significant relationship between Shari'ah Board and bankperformance.

H2: There is a significant relationship between board structure and bank performance.

H3: There is a significant relationship between audit function and bank performance.

3. Data and Methodology:

The purpose of this paper is to examine the impact of *Shari'ah* board and corporate governance on Islamic banking performance. For this purpose, the study employed the data of 16 banks from 2012-2015, which represents 11.2% of total banking sectors of Pakistan. This study uses panel data of variables in the system.

There are four dimensions of monitoring mechanisms used to study the relationship between corporate governance and performance. Additionally, control variablesare also added to account for the banks level differences in Pakistan. The measurement of all variables used within the system is summarized in table 2. We assumed a direct association between Shari'ah board and others corporate governance practices (independent variables) and performance of Islamic banks (as dependent variable). By employing Pooled OLS model, the relationship between among variables is analyzed by employing this model:

$$CP_{it}=\alpha+\beta 1SB_{it}+\beta 2CD_{it}+\beta 3BOSZit+\beta 4INDB_{it}+\beta 5CAR_{it}+\beta 6SIZE_{it}+\beta 7GOV_{it}+V8FOR_{it}+\beta 9EQTA_{it}+\beta 10NLTA_{it}+\beta 11GDPC_{t}+\varepsilon_{it}$$

Where: CP_{it} = Corporate performance measured by Tobin's Q and ROA of Bank i in time tSB_{it} = Shari'ah Board; $BOSZ_{it}$ = number of member in a board of bank i in time t; CD_{it} = CEO Duality of bank i in time t; GOV_{it} = Government shareholding in bank i in time t; FOR= Foreign shareholding in bank i in time t; $INDB_{it}$ = Percentage of independent directors of bank i in time t; CAR_{it} = Capital adequacy ratio of bank i in time t; $NLTA_{it}$ =Net loans to total assets of bank i in time t; $GDPC_{it}$= GDP per

capita; $EQTA_{it}$= Protection $SIZE_{it}$ = banks size is computed as total assets of bank I in time t and ε_{it} = random error

Table 2. Variables Description and its Measurement:

Variables		Description
Operational efficiency	Tobin's Q	The ratio of the bank market value to its book value.
	ROIA	Operating profit divided by average assets
Shari'ah Board	SB	Equals 1 if *Shari'ah* supervisory Board exist, zero otherwise
Government	GOV	Equals 1 if the government shareholding in the bank is at least 5%, and zero otherwise
Foreign	FOR	Equals 1 if the foreign shareholding in the bank is at least 5%, and zero otherwise
Board size	BSIZE	Number of directors in the board
Board independence	BIND	Percentage of independent directors in a of directors
CEO duality	CD	If CEO is Chairman of Board, its value1 otherwise zero
Capital Adequacy	CAR	It is calculated as *Equity/assets*
Big 2 Auditor	BIG2	if the bank is audited by Big 2 national external auditors, its value1 otherwise zero
Firm size	FSIZE	Logarithm of total assets
Protection	EQTA	Equity to total assets a measure of level of protection afforded to the bank by the equity.
Net loans to total assets	NLTA	Net loans to total assets an indicator of the proportion of assets that are tied up in loans
GDPper Capita	GDPPC	Log of GDP per capita.

4. Results and Discussions:

The descriptive summary of all variables which are employed in this study are presented in tables 3. The results indicate thatthe average return on assets of Islamic banks used in this study is 10.36%; while Tobin's Q average is 14.68%. However, the mean of all other independent variables are positive.The firm size mean is 0.5049, which varied across the banks. In average total equity over total assets is 12.52 and standard deviation is 16.37. As Protection means is 0.7243; Net loans to total assetsmean is 0.3468and Shari'ah Board mean is 0.6180respectively. In terms of board composition, the average board size is 6.9643 and board independence is 36.38 % respectively.However,in case of foreign shareholdings means is 0.2496; whereas thegovernment's shareholdings means is0.3247.Among others indicators; average gross domestic per capita is 0.3264. We also find outs that the CAR means is 9.76 8%.

Table 3: Descriptive statistics summary of Variables

Variables	Mean	Median	Std. deviation
Tobin’s Q	0.14689	0.08379	1.07804
ROIA	0.10367	0.06438	0.90319
SB	0.61801	0.46901	0.26738
GOV	0.32476	0.29820	1.83609
FOR	0.24963	0.16389	0.91602
BOSIZE	6.96430	3.47216	0.78946
BIND	0.36859	0.15634	0.80879
CAR	0.09765	0.06459	0.90368
SIZE	0.50496	0.41920	0.86732
EQTA	0.72438	0.60674	0.08679
NLTA	0.34689	0.16437	1.06418
GDPPC	0.32647	0.20956	0.80936

Table 4: Correlation Matrix of Variables use in study

Variables	Q	ROIA	SB	GOV	FOR	BSIZE	BIND	CAR	EQTA	NLTA
ROIA	0.146									
SB	0.087	0.064								
GOV	0.218	0.469	0.078							
FOR	0.324	0.398	0.503	0.836						
BOSIZE	0.249	0.163	0.267	0.319	0.268					
BIND	0.464	0.472	0.069	0.481	0.408					
CAR	0.206	0.428	0.158	0.508	0.305	0.249				
SIZE	0.789	0.083	0.325	0.023	0.183	0.408	0.312			
EQTA	0.495	0.545	0.490	0.526	0.490	0.236	0.485	0.098		
NLTA	0.351	0.236	0.037	0.418	0.078	0.406	0.083	0.296	0.328	
GDPPC	0.495	0.408	0.382	0.503	0.342	0.495	0.545	0.345	0.282	0.243

Note: Dep. Var., Tobin’s Q and ROIA as Corporate performance and Ind. Variables are SB = Shari’ah Board; BOSZ = number of member in a board; GOV = Government shareholding; FOR= Foreign shareholding; INDB = Number of independent Directors; CAR = Capital adequacy ratio; NLTA =Net loans to total assets; GDPC= GDP per capita; EQTA= Protection SIZE = total assets.

The above findings support the null hypothesis that the bank's performance has a significant association with Shari’ah Board; Capital adequacy ratio GDP and others variables in this study. These results are consistent with existing literature.

The result of Pooled OLS regression analysis of all Shari’ah Board; corporate governance proxies and bank specific variable by employing both performance measures of Tobin’s Q and ROIA is provided in tables 4 and 5. The R2 in all models is found to be very consistent with and without the control variable. The results in table 4 indicated that government shareholding has a negative

association with Tobin's Q. on the other hand, an accounting based measure (ROIA) results in table 5 indicate an insignificant and reverse relationship. It means that market-based measure is good as compare to accounting measure to capture the ownership shareholding with the bank corporate performance. The identical results are obtained when foreign shareholdings incorporated as ownership proxy. The results in table 4 and 5 which obtained from Tobin's Q and ROIA as dependent variables indicated that foreign ownership has a negative (significant) impact on Tobin's Q as well as ROIA. By using Shari'ah Board as corporate governance proxy also illustrates the positive and significant association with Tobin's Q as bank performance at 1% significant level. Same results are obtained, when we employed the ROIA as the accounting-based measure.

Results on table 5 showed that board size is negatively related to Tobin's Q using large shareholders in the specification but not statistically significant. However, the sign of the relationship changes when both foreign and government shareholdings are treated as proxies for ownership monitoring mechanism. None of the models successfully indicate significant relationship when ROIA is substituted as a proxy for corporate performance. Board independence is also found to have the same relationship with board size with controlling for size. The results also revealed that CEO Duality is insignificant in explaining corporate performance when Tobin's Q is used as the performance measure but showed a statistically significantly negative relationship when ROIA is used as the performance measure for all models. The regression test exhibited that the relationship between Capital Adequacy and Tobin's Q as well as ROAis positive and statistically significant. Regarding Bank Age variables, the estimated coefficients concluded that Bank Age significantly affects Tobin Q and ROA measure of bank performance at 1% and 5% levels respectively. This result regarding bank age is consistent with the results of the studies of [(24)] [(25)].Similarly, there is a positive (significant) association between external auditors and Tobin's Q as well as ROA. Moreover, GDPC variable results showed a statistically insignificant relationship with Tobin's Q. However, the variable is found to have a statistically significant positive relationship with ROA at 1% level of significance. The NLTA and size of the firm has a positive and significant impact on ROA,althoughEQTA is negative and insignificance impact on ROA. We separate out the large shareholders into different shareholders category, and we found that the presence of government ownership is detrimental to corporate performance, and this confirmed previous findings between government shareholdings and corporate performance of Islamic banks. Nevertheless, the same cannot be said for foreign shareholding. While it has a negative effect with Tobin's Q, the positive relationship with ROA might give some support to the evidence in non-banks study where the presence of foreign shareholders improves the performance of the firms. The positive relationship might be an indication of initial success of the liberalization of the Islamic banking industry in Asia whereby the foreign players with larger capital are moving aggressively to tap into the new markets. In terms of internal control monitoring mechanisms, we found that CEO Duality is damaging to corporate performance for Islamic banks.

Table 5. Pooled OLS Results by using Tobin’s Q as Dependent Variable

Variables	Model1	Model2	Model3
Constant	-0.079800 (0.590)	-0.079800 (0.904)	0.274305 (0.836)
SB	0.410928 (0.595)	0.398665 (0.054)	0.290616 (0.956)
GOV	-0.037264*** (0.003)	-0.040852*** (0.006)	-0.048690*** (0.012)
FOR	0.095488 (0.736)	-0.026795 (0.873)	0.047133 (0.476)
BOSIZE	0.078428 (0.019)	0.083624 (0.012)	0.082910 (0.001)
BIND	0.019696 (0.736)	-0.013951 (0.576)	-0.012543 (0.982)
CD	-0.003728 (0.879)	-0.001869 (0.462)	-0.001750 (0.001)
CAR	0.0364106 (0.574)	0.077504 (0.965)	0.052195 (0.365)
BIG2	0.063094 (0.005)	0.062973 (0.123)	0.048152 (0.317)
FSIZE	0.148542 (0.065)	0.189564 (0.008)	0.126452 (0.907)
EQTA	-0.068743 (0.028)	-0.048692 (0.019)	-0.052893 (0.367)
NLTA	0.025429 (0.005)	0.028369 (0.009)	0.030152 (0.018)
GDPPC	0.154283 (0.104)	0.186742 (0.176)	0. 205483 (0.212)
Q_{t-1}			0.048542 (0.002)
Adjusted R2	0.595296	0.679435	0.604578

Note: Note: Dep. Var., Tobin’s Q and ROA as Corporate performance and Ind. Variables are SB = Shari’ah Board; BOSZ = number of member in a board; CD = CEO Duality; GOV = Government shareholding; FOR= Foreign shareholding; INDB = Number of independent Directors; CAR = Capital adequacy ratio; NLTA =Net loans to total assets; GDPC= GDP per capita; EQTA= Protection and SIZE = total assets.

*Significant at 10% level. **Significant at 5% level. ***Significant at 1% level.

Table 6.Regression Result Using ROA as the Dependent Variable.

Variables	Model1	Model2	Model3
Constant	0.509951 (0.590)	0.454549 (0.836)	0.349001 (0.460)
SB	0.07361 * (0.032)	0.069748** (0.029)	0.070934* (0.040)
GOV	0.04086 (0.317)	0.03852 (0.825)	0.03369 (0.093)
FOR	0.018895 (0.015)	0.016705 (0.127)	0.010845 (0.904)
BOSIZE	0.036974 (0.840)	0.029564 (0.715)	0.050846 (0.513)
BIND	-0.054628 (0.980)	-0.012486 (0.607)	-0.016583 (0.414)
CD	-0.029733** (0.008)	-0.020736* (0.012)	-0.028184* (0.016)
CAR	0.002861 (0.087)	0.002797 (0.015)	0.002883 (0.029)
BIG2	0.032548 (0.001)	0.031650 (0.007)	0.032347 (0.002)
FSIZE	0.024837 (0.072)	0.028957 (0.085)	0.026384 (0.935)
EQTA	-0.020698 (0.137)	-0.029475 (0.561)	-0.040762 (0.561)
NLTA	0.126809** (0.006)	0.108965** (0.089)	0.098441** (0.020)
GDPPC	0.028569*** (0.000)	0.030486** (0.019)	0.045748** (0.009)
ROA_{t-1}			0.086941*** (0.019)
Adjusted R2	0.396985	0.434674	0.481678
Sargan test	0.367890	0.246719	0.167892

Note: Note: Dep. Var., Tobin's Q and ROA as Corporate performance and Ind. Variables are SB = Shari'ah Board; BOSZ = number of member in a board; CD = CEO Duality; GOV = Government shareholding; FOR= Foreign shareholding; INDB = Number of independent Directors; CAR = Capital adequacy ratio; NLTA =Net loans to total assets; GDPC= GDP per capita; EQTA= Protection SIZE = total assets.

**Significant at 10% level. **Significant at 5% level. ***Significant at 1% level.*

Thus, recommendations of having separate leadership by the Code on Corporate Governance by the authorities in the affected countries proved to be a suitable governance mechanism across all firms. The disclosure-monitoring system through the selection of external auditors by the banking firms is found to be consistent with existing researchwhere it is significantly positively related to banking performance. Thus, the External Auditors will benefit the shareholders of Islamic banks since it provides credibility to information for shareholders when making investment decision.

Moreover, the study employs the GMM estimation by adding lag of both explanatory variables (Qt-1 and ROAt-1), firstly, to remove the endogeneity and other issues of panel data. Further, firm performance level cannot adjust instantly following the transformation of the banks' sources of capital and other capital generated variables; it also uses one to two period lag of endogenous variable as instruments in levels, and includes one period lag of dependent variable in the explanatory variable list. The GMM analysis results in table 5 and 6 from a model 3 shows that the coefficient estimate for is significant at the 1% level of significance. The Sargan test has employed to check the validity of the instruments; the diagnostic tests for both instruments are satisfactory. The Sargan p-value for instruments is insignificant respectively. Practically, the study suggests that finding about the impact of corporate governance practice on bank performance arenot driven by unobserved firm effects, such as simultaneous endogeneity, or dynamic endogeneity.

Conclusions:

The objective of this paper is to examine the effect of Shari'ahsupervision; corporate governance on the performance of Islamic banks in Pakistan and study findings have generated a perspective on Shari'ah supervision and corporate governance monitoring mechanisms in the banking sector. Overall, it is found that all ownership controlling procedures have shown a negative relationship with corporate performance of the the financial firms in the emerging markets of Asia. However, between the two corporate performance measures, Tobin's Q is able to explain the relationship better in all the models while ROA can yield a significant relationship only when a large number of shareholders is used as the independent variable.

It is also found that none of the inside Control system displayed a statistically significant association with market-based corporate performance; nevertheless, CEO Duality (which is one aspect of internal monitoring) provides sufficient evidence that accounting measure can explain the relationship better. However, theresults maintain that the Big 3 Auditors played a more significant part in providing the information than the others credit Rating Agencies. This may result in better monitoring mechanism of disclosure for the firms in Pakistan, particularly, Islamic banking corporation. In terms of ownership monitoring mechanism, our study confirmed that the presence of large blockholders leads to poor performance for the banking firms, which is consistent with previous researches on non-banks firms. In terms of internal control monitoring mechanisms, it is also explained that the dual role of CEOs is detrimental to the business performance for both non-

banking and banking firms while the disclosure monitoring mechanism through the appointment of Big 3 external auditors by the banking firms is found to be consistent with previous studies on non-bank firms where it is significantly positively related to corporate performance.

Thus study results displayed some similarities between banks and others firms corporate-governance monitoring systems. However, the nature of the Islamic banking firms itself exposed certain differences in the monitoring mechanisms between the two groups. The research also found that banks in the Asian emerging markets are better governed as a result of key governance reforms since the financial crisis. It also shows that in certain aspects, banking firms in the emerging Asian markets appreciate the importance of good governance in terms of separating the positions of CEO and Chairman as well as efforts on improving the quality of corporate disclosure. Examining the outcome from corporate governance and Shari' ah principles impact on Islamic banks performance are similar in certain aspects of non Islamic banks that has its own unique features that differentiate their corporate governance monitoring mechanisms. However, it is essential to note that the findings are generated during the early stage of the adoption of Shari' ah principles and corporate governance in Pakistan.

There are a number of recommendations can be made for the future research. We have a limitation of availability data, in the future study; a larger pool of observations and time-period should be used so that banks performance and monitoring systems association can be examined, which will help the ongoing Islamic bank transformations. In terms of ownership, future research may treat ownership concentration; and government and foreign ownership according to percentage instead of dummy when more data is available. The advantage of having such form of data format would allow the analysis to capture the appropriate level of ownership, which may contribute to a better or poor corporate performance of banking firms.

References:

1. Johnson, Simon, Peter Boone, Alasdair Breach, and Eric Friedman. "Corporate governance in the Asian financial crisis." *Journal of financial Economics* 58, no. 1, (The Netherlands, 2000), p.141-186
2. Knapp, Michael C., and Carol A. Knapp. "Europe's Enron: Royal Ahold, NV." *Issues in Accounting Education* 22, no. 4 (2007), p.641-660
3. Markham, Jerry W. *A* Financial History of the United States: From Enron-Era Scandals to the Subprime Crisis (2004-2006); From the Subprime Crisis to the Great Recession (2006-2009), (Routledge, USA, 2015)
4. Essen, Marc, Peter - Jan Engelen, and Michael Carney. "Does "Good" Corporate Governance Help in a Crisis? The Impact of Country and Firm Level Governance Mechanisms in the European Financial Crisis." *Corporate Governance: An International Review* 21, no. 3, (The Netherlands 2013), p.201-224

5. Gugler, Klaus, Dennis C. Mueller, and B. BurcinYurtoglu. "The impact of corporate governance on investment returns in developed and developing countries." *The Economic Journal* 113, no. 491, (USA 2003), F511-F539
6. Erkens, David H., Mingyi Hung, and Pedro Matos. "Corporate governance in the 2007–2008 financial crisis: Evidence from financial institutions worldwide." *Journal of Corporate Finance* 18, no. 2, (The Netherlands 2012), p.389-411
7. Aebi, Vincent, Gabriele Sabato, and Markus Schmid. "Risk management, corporate governance, and bank performance in the financial crisis." *Journal of Banking & Finance* 36, no. 12, (The Netherlands 2012), p.3213-3226
8. Klapper, Leora F., and Inessa Love. "Corporate governance, investor protection, and performance in emerging markets." *Journal of corporate Finance* 10, no. 5, (The Netherlands 2004), p.703-728
9. Balduccini, Bruno, and AminaAkram. "Shariah's Next Frontier." *International Financial Law Review.* 32, (USA 2013), p.53
10. ShahzadBukhari, Khuram, Hayat M. Awan, and Faareha Ahmed. "An evaluation of corporate governance practices of Islamic banks versus Islamic bank windows of conventional banks: A case of Pakistan." *Management Research Review* 36, no. 4, (UK 2013), p.400-416
11. Mitton, Todd. "A cross-firm analysis of the impact of corporate governance on the East Asian financial crisis." *Journal of financial economics* 64, no. 2, (The Netherlands 2002), p.215-241
12. Baek, Jae-Seung, Jun-Koo Kang, and Kyung Suh Park. "Corporate governance and firm value: Evidence from the Korean financial crisis." *Journal of Financial economics* 71, no. 2, (The Netherlands 2004), p.265-313
13. Coles, Jerilyn W., Victoria B. McWilliams, and Nilanjan Sen. "An examination of the relationship of governance mechanisms to performance." *Journal of management* 27, no. 1, (USA 2001), p.23-50
14. Haniffa, Roszaini M., and Thomas E. Cooke. "The impact of culture and governance on corporate social reporting." *Journal of accounting and public policy* 24, no. 5, (The Netherlands 2005), p.391-430
15. Jensen, Michael C. "The modern industrial revolution, exit, and the failure of internal control systems." *the Journal of Finance* 48, no. 3 (1993), p.831-880
16. Eisenberg, Theodore, Stefan Sundgren, and Martin T. Wells. "Larger board size and decreasing firm value in small firms." *Journal of financial economics* 48, no. 1, (The Netherlands 1998), p.35-54
17. Cornett, Marcia Millon, Gayane Hovakimian, Darius Palia, and Hassan Tehranian. "The impact of the manager–shareholder conflict on acquiring bank returns." *Journal of Banking & Finance* 27, no.1, (The Netherlands 2003), p.103-131
18. Adams, Renée B., and Hamid Mehran. "Is corporate governance different for bank holding companies?." *Available at SSRN 387561,* (2003).
19. Cook, Douglas O., Arthur Hogan, and Robert Kieschnick. "A study of the corporate governance of thrifts." *Journal of Banking & Finance* 28, no. 6, (The Netherlands 2004), p.1247-1271

20. Petra, Steven T. "Do outside independent directors strengthen corporate boards?." *Corporate Governance: The international journal of business in society* 5, no. 1, (United Kingdom 2005), p.55-64
21. Niinimäki, J-P. "Intertemporal diversification in financial intermediation." *Journal of banking & finance* 25, no. 5, (The Netherlands 2001), p.965-991
22. Claessens, Stijn, and Joseph PH Fan. "Corporate governance in Asia: A survey." *International Review of finance* 3, no. 2, (USA 2002), p.71-103
23. Johnes, Jill, Marwan Izzeldin, and Vasileios Pappas. "Efficiency in Islamic and conventional banks: Evidence from the Gulf Cooperation Council countries." *Available at SSRN 2411974* (2014).
24. Athanasoglou, Panayiotis, Manthos Delis, and Christos Staikouras. "Determinants of bank profitability in the South Eastern European region."(2006).
25. Dietrich, Andreas, and Gabrielle Wanzenried. "Determinants of bank profitability before and during the crisis: Evidence from Switzerland." *Journal of International Financial Markets, Institutions and Money* 21, no. 3, (The Netherlands 2011), p.307-327

Islamic Banking Braches Network (*As June 2015)*

Type	*Name of Bank*	*No of Branches**
Islamic Banking	*AlBaraka Bank (Pakistan) Limited*	*121*
	BankIslami Pakistan Limited	*123*
	Burj Bank Limited	*74*
	Dubai Islamic Bank Pakistan Limited	*174*
	Meezan Bank Limited	*474*
Islamic Braches of Conventional Banking	*Allied Bank Limited*	*6*
	Askari Bank Limited	*63*
	Bank AL Habib Limited	*26*
	Bank Alfalah Limited	*156*
	Faysal Bank Limited	*63*
	Habib Bank Limited	*43*
	Habib Metropolitan Bank Limited	*12*
	MCB Bank Limited	*34*
	National Bank of Pakistan	*51*
	Silkbank Limited	*10*
	Sindh Bank	*5*
	Soneri Bank Limited	*15*
	Standard Chartered Bank (Pakistan) Limited	*10*
	Summit Bank Limited	*6*
	The Bank of Khyber	*59*
	The Bank of Punjab	*37*
	United Bank Limited	*25*
Sub Branches	*AlBaraka Bank (Pakistan) Limited*	*14*
	Askari Bank Limited	*2*
	BankIslami Pakistan Limited	*95*
	Faysal Bank Limited	*1*
	Habib Bank Limited	*2*
	United Bank Limited	*1*

Source: Banking Policy & Regulations Department, State Bank of Pakistan.
Footnote

[1]Mudarabah and Musharakah are contracts that based on the profit-and- loss sharing technique (PLS). In Mudarabah an investor (usually an Islamic bank) and an entrepreneur (individual or institutional) enter a joint venture where the investor provides the necessary funds and the entrepreneur provides knowledge. Murabahah, in contrast, is a contract based on cost-plus-profit approach.

[2] Fee-based services include the widely used contracts of Murabahah and Ijarah. The bank arranges to sell a good to a customer and it charges a risk-adjusted fee. Ijarah is a lease contract where the bank leases an asset to a customer who pays fees to use the asset.